# INTERNAL AUDIT AND CONTROL OF NON-APPROPRIATED FUNDS

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## PREFACE

Non-appropriated funds are "the moneys which support certain revenue-producing, welfare, and sundry activities which are not provided for in congressional appropriations but are necessary adjuncts to the armed forces."[1] They are instrumentalities of the United States, set up for administrative use, and are separate and distinct from the funds recorded on the books of the Treasury and General Accounting Office. They are usually for the purpose of contribution to the welfare, comfort, or pleasure of military or civilian employes.

"Non-appropriated funds include, but are not limited to:

> (a) Funds received and expended for Navy accounts and organizations such as Welfare and recreation funds derived from Ship's Stores, Navy and Marine Exchanges; funds received and expended by officers' and enlisted men's clubs; Navy employees' relief funds; Civil Cervice employees' association funds; and employee-operated cafeteria funds.
>
> (b) Funds received and expended by employee credit unions or other organizations which have Federal or State charters. These include all credit unions in the Naval Establishment.
>
> (c) Funds derived from gifts, games, entertainments and collections."[2]

The purpose of this paper is to explore the internal audit and control procedures which are pertinent to Non-appropriated funds, with emphasis upon the prevention of fraud and the safeguarding of Non-appropriated fund assets. In so doing, it is realized that any system of internal

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[1]SR 320-5-1, Dictionary of United States Army Terms, p. 191.

[2]Office of the Comptroller of the Navy, Internal Auditing - Principles, Policies, Minimum Standards and Objectives, Department of the Navy, Washington, D. C., May 1951, p. 15.

audit and control is designed primarily for the purpose of maximizing the efficiency of operations. The prevention of fraud is an important, but ancillary purpose. But it is fraud in the administration of these funds, and not mediocrity or mere inefficiency of operations, which results in the diversion of much military manpower to official investigations and courts-martial, with the Commanding Officer almost invariably an interested party and sometimes a defendant. Many Commanding Officers have suffered embarrassment or blemished service records resulting from frauds perpetrated by their employes and military subordinates in the administration of Non-appropriated fund activities. It is hoped that this paper will in some measure serve to stimulate the Commanding Officer's interest in this often-neglected, but potentially very troublesome area.

# CHAPTER I

## EMBEZZLEMENT AND FRAUD[1]

The Commanding Officer, when confronted with an audit report in which areas of loose control are pointed out, too often reacts with an expression similar to the following: "Controls are all well and good, but after all I trust my people, and I will not be too concerned about a little laxness in control." The typical Commanding Officer will duly note such a report, pass it on to the people concerned, with a mild admonition to "straighten it out," and turn his attention to more pressing business. The experienced auditor, however, has learned the truth in the saying "those we <u>do</u> trust <u>can</u> steal; those we <u>don't</u> trust <u>can't</u> steal."[2]

Many businessmen put employes in two broad categories of honesty. First, there are those who simply are not morally capable of fraud under any circumstances. Fortunately, these are in the majority, and we do not have to worry about them. In the second category are those who consider themselves to be honest and actually do not think they will ever be dishonest. But when a person in this category encounters financial difficulties - be it from sickness in the family, high living,

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[1]To embezzle is "to appropriate fraudulently to one's own use, as property entrusted to one's care." Hence embezzlement implies fraudulent appropriation by a breach of trust. Fraud, in turn is defined in its legal sense as "an intentional perversion of truth to induce another to part with some valuable thing belonging to him, or to surrender a legal right." In practice, these terms are used more or less interchangeably, as will be done in this paper.

[2]Original source undetermined.

gambling, or women[1] - and at the same time is exposed to a loose system of internal audit and control, he has an open invitation to steal. The feeling is quite general, in auditing and fidelity insurance circles, that management is largely responsible for the defalcations in this second group. A prominent fidelity insurance expert put it this way:

> "Dishonesty is usually the result of the direct and premeditated acts of the individual. However, too often embezzlers are abetted in their stealings by poor accounting systems, lack of internal control, and inadequate periodic audits. When an employer's method of operations makes it easy for an individual to steal, unfair temptation is placed before the employe. Should either a real or a fancied need for money arise, such as for large medical expenses, a promising business venture or other gamble, it is difficult to predict whether an indiviidual will succumb to temptation.[2]

It follows that a Commanding Officer may well deem it his duty to protect his employes and his military subordinates from themselves by keeping temptation out of their way.

It is difficult for a casual researcher to obtain statistics on the extent of fraud in the administration of military nonappropriated funds. This stems from two causes: first, the requirement for administrative privacy bars the researcher from access to official files of reports of investigations and audit reports concerning defalcations. Second, as in the business world, many defalcations simply are not reported, and many continued undiscovered. These difficulties are not important, however, because nonappropriated fund activities are not unique; they have very similar counter-

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[1]The familiar triple incentive for embezzlement - "redheads, rum, and races" - has been superseded by more righteous motives, as follows: (1) to keep families together, including the payment of education bills; (2) to pay hospital bills; and (3) to keep up with the Jones'.

[2]Mr. A. F. Lafrentz, Chairman of Board, American Surety Co., in Insurance World 1957 Property and Liability, p. 35.

parts in the business world. The accounting systems and the systems of internal audit and control employed in the administration of these activities are very similar to those employed in business. Too, the people concerned with the administration of nonappropriated funds are a good cross-section of the population. Hence it can be safely assumed that the difficulties encountered by business in the area of fraud are also encountered by the military, and a discussion of one will also serve for the other.

An examination of the Federal Bureau of Investigation's Uniform Crime Reports[1] reveals that a total of 18914 persons in the United States were charged[2] with embezzlement in 1956. This figure represents a rate of 29 persons per 100,000 of population, which in itself does not appear to be particularly alarming. But the fact is that the conventional armed robber is a rank amateur in comparison with the trusted employe when it comes to theft. Professional thieves stole about $450 million in goods and money in 1957. The embezzler, whose crime is incidental to a legitimate career, made off with at least $500 million. Accurate estimates of total losses by embezzlements cannot be made because many such losses go unreported for one reason or another.[3] Undoubtedly, many remain undetected. A national detective agency that handles many industrial accounts

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[1]Uniform Crime Reports for the United States, Issued by Federal Bureau of Investigation, U.S. Department of Justice, Washington D. C., 1957 semi-annual bulletin, 1957, vol. XXVII, Number 1, p. 56. Government Printing Office, Washington D.C. 1957.

[2]Note that the figure 18,914 represents the number of persons charged, and does not represent the number of persons convicted.

[3]Reasons for failure to report embezzlements include the following: (1) Embarrassment of management at having been so foolish as to trust the wrong man; (2) Pity for the embezzler; (3) fear that prosecution may be unsuccessful, exposing the company to counter-suits; (4) fear that unfavorable publicity may hurt business; and (5) restitution, or promise of same, by the defaulter.

places the annual loss to embezzlers at nearly $750 million. Many police and fidelity insurance experts believe that the true, although unascertainable, total is between $1 billion and $2 billion. Coupled with this high loss due to embezzlements is the fact that employe embezzlements have steadily risen in recent years - faster, in proportion, than the amount of money in circulation - and now rank with fire as a major cause of business loss. The tragedy of this unhappy situation is that only about $30 million of the annual loss to embezzlers is covered by fidelity insurance. The remainder comes directly out of business profits.

Embezzlement is insidious and shocking because the thief frequently is a trusted employe who has served his organization faithfully for many years. The embezzler can be just about anybody.

> The most distinctive facts regarding embezzlement are (1) the very high frequency of the offense and (2) its incidence in all strata of society. The discomforting likelihood, plainly indicated as one probes the data, is that if everyone was not sometime in his life an embezzler, at least a large percent of all types of person in every profession, vocation, social and economic status, has sometime committed embezzlement.[1]

The United States Fidelity and Guaranty Company published a report in which 1001 cases of mercantile embezzlement were taken at random from their files and studied.[2] 47 states, most provinces of Canada, and several foreign countries where American concerns have branches, were represented in this study. Nearly every type of business was represented. The list of embezzlers included men and women in a wide range of occupations, all levels of importance, and all adult age groups. They cost business over $6 million in money and property. The average man embezzled $6,363.02, the

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[1] Jerome Hall, Theft, Law and Society, Indianapolis, Bobbs-Merrill Company, 1935, p. 299.

[2] United States Fidelity and Guaranty Company, 1001 Embezzlers, Baltimore, Author, 1937.

average woman $4,129.42. The total loss exceeded the bond coverage by 90%. The study draws a picture of the "typical" embezzler as follows:

> Your typical embezzler belongs in the white collar class. He is thirty-six years old. He is married. He has a wife and two children. He is not psychopathic or of feeble mind, nor does he live in a neighborhood where crime is widespread. His upbringing has been good. He is not the lowest paid person in his employer's organization, nor is he the highest. His friends and very often his wife imagine that his salary is $300.00 a month or more, but it is nearer $175.00 a month.[1] He has a high school education. He lives comfortably. He has a medium priced automobile, last year's model, on which a balance is still owing. His traveling has been confined to occasional week-ends and a two-week vacation in the summer. He is a good mixer. He participates in social and community affairs. He enjoys a good time. He likes a drink, but he rarely takes it during business hours. He lives in every state in the Union, in every province of Canada, in large cities, in small cities. He is employed in every type of business. He is competent and smart. He has held his position for five and a half years. His employer regards him favorably and he has honestly earned the position of trust to which he has attained. In short, so far as his past record is concerned, he is a regular fellow, a normal individual with a better than average business reputation and future. Yet he becomes an embezzler.

The Federal Bureau of Investigation's "Uniform Crime Reports"[2] includes an interesting breakdown of the identity of embezzlers by age groups. The 13,494 arrests for embezzlement in 1477 cities of 2500 or more population or more, tabulated by age groups, is as follows for 1956.[2]

| Age Group | Number | Percentage |
|---|---|---|
| Under 15 | 79 | .58 |
| 15-19 | 383 | 2.84 |
| 20-24 | 2130 | 15.79 |
| 25-29 | 2495 | 18.49 |
| 30-34 | 2641 | 19.57 |
| 35-39 | 2088 | 15.48 |
| 40-44 | 1424 | 10.56 |
| 45-49 | 928 | 6.87 |
| 50 & over | 1326 | 9.82 |
| Totals | 13494 | 100.00 |

[1]This report was published at a time when $175.00 a month was a substantial salary.

[2]Uniform Crime Reports for the United States, Vol. XXVII Number 2, Annual Bulletin, 1956, Government Printing Office, Washington, D.C., p. 109.

Another tabulation in that reference shows the incidence of embezzlement by geographical areas, as follows:[1]

| Area | Arrests for embezzlement, Rate per 100,000 inhabitants |
|---|---|
| South Atlantic (including D. C.) | 66.9 |
| East South Central | 52.9 |
| Mountain | 45.0 |
| East North Central | 30.0 |
| West South Central | 27.5 |
| Pacific | 25.4 |
| West North Central | 25.0 |
| New England | 23.4 |
| Middle Atlantic | 16.1 |

The above tabulation of embezzlers by age groups is probably about the same as the distribution of our working population by age groups, and is significant only in that it supports the previous assertion that the embezzler can be just about anybody. The tabulation of embezzlers by geographical areas is interesting, particularly to a manager or a Commanding Officer, in that it indicates that an embezzler is more than twice as likely to be encountered at a naval activity in the District of Columbia and southward along the eastern seaboard as he is north of the District and on the west coast.

The preceding discussion has briefly outlined the incidence and cost of embezzlement, and has attempted to identify the embezzler. The conclusion at this point is that every businessman stands a good chance of being victimized by an embezzler, who will probably be a trusted employee and who will probably be aided by his boss' innocent collusion - in the form of complacency, blind trust, or loose control. A brief examination of the reasons which compel a good man to turn thief may now be in order.

Reference has been made to two broad categories of honesty into

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[1] *Ibid*., p. 5.

which employes may be divided - those who simply could not be dishonest under any circumstances, and those who think they are honest, but, given an urgent need for money, can rationalize a breach of trust. However, this theory is not necessarily shared by all experienced surety officials, some of whom are less charitable and feel that anyone will embezzle when temptation is great and concealment is easy. Dr. Donald R. Cressey of U.C.L.A. offered the following theory in his Ph.D. Thesis:

> Trusted persons become trust violators when they conceive of themselves as having a financial problem which is non-shareable, have the knowledge or awareness that this problem can be secretly resolved by violation of the position of financial trust, and are able to apply to their own conduct in that situation verbalizations which enable them to adjust their conceptions of themselves as trusted persons with their conceptions of themselves as users of the entrusted funds or property.[1]

Thus Dr. Cressey visualizes three conditions which must precede an embezzlement: (1) a pressing non-shareable financial problem, which concurs with (2) opportunity to embezzle without likelihood of detection, and (3) rationalizing the embezzlement in terms of its being a temporary "borrowing."

United States Fidelity and Guaranty's "1001 Embezzlers" includes a tabulation of the various reasons which compeled these persons to embezzle, as follows:[2]

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[1] Dr. Donald R. Cressey, quoted in Theft, Law and Society, by Jerome Hall, Indianapolis, 1935, p. 303.

[2] United States Fidelity and Guaranty Company, 1001 Embezzlers, Baltimore, Author, 1937.

MEN

| | Number | Per Cent |
|---|---|---|
| Revenge - - - - - - - - - - - - - - - - - - - - | 1 | .1 |
| Dishonest Son - - - - - - - - - - - - - - - - | 1 | .1 |
| Blackmail - - - - - - - - - - - - - - - - - - - - | 2 | .2 |
| Saving for a Rainy Day - - - - - - - - - - - | 2 | .2 |
| Replacing Lost Money - - - - - - - - - - - - | 2 | .2 |
| Wives - - - - - - - - - - - - - - - - - - - - - - | 7 | .7 |
| Operation of Another Business - - - - - - - - | 13 | 1.4 |
| Mentally Irresponsible - - - - - - - - - - - | 14 | 1.5 |
| Inadequate Income - - - - - - - - - - - - - - | 18 | 1.9 |
| Sickness of Wife, Son, or Daughter - - - - - | 57 | 5.9 |
| Speculation - - - - - - - - - - - - - - - - - - | 84 | 8.7 |
| Women - - - - - - - - - - - - - - - - - - - - - - | 102 | 10.6 |
| Bad Business Managers - - - - - - - - - - - - | 133 | 13.8 |
| Accumulation of Debts - - - - - - - - - - - - | 156 | 16.2 |
| Living Above their Means - - - - - - - - - - - | 161 | 16.7 |
| Gambling and/or Drink - - - - - - - - - - - - | 169 | 17.6 |
| Criminal Characters - - - - - - - - - - - - - | 41 | 4.2 |
| Total | 963 | 100.0% |

WOMEN

| | Number | Per Cent |
|---|---|---|
| Sickness in Family - - - - - - - - - - - - - - | 2 | 5.3 |
| Dependents - - - - - - - - - - - - - - - - - - - | 4 | 10.6 |
| Operation of another Business - - - - - - - - | 1 | 2.6 |
| Mentally Irresponsible - - - - - - - - - - - - | 3 | 7.9 |
| Gambling - - - - - - - - - - - - - - - - - - - - - | 2 | 5.3 |
| Men - - - - - - - - - - - - - - - - - - - - - - - - | 2 | 5.3 |
| Accumulation of Debts - - - - - - - - - - - - - | 11 | 28.8 |
| Living Above Their Means - - - - - - - - - - - | 13 | 34.2 |
| Total | 38 | 100.0% |

Reasons such as the above, then, can compel a basically honest person to "borrow". Many, most, or all persons have the traits of character such that when exposed to a sufficiently compelling need for money they can rationalize "borrowing" from their employer. If an employe develops such an urgent, non-shareable financial problem it is not likely that the Commanding Officer will learn of it. But a prospective embezzler may display certain characteristics and habits which may lead the Commanding Officer or the Manager to wonder, and to question. The inqusitive, questioning mind

can be a valuable adjunct to internal control, for simple questions, having little relation to principles of internal control, have led to the discovery of many defalcators. For example, it was the inquisitive nature of a new employe which led to the discovery of the notorious Minnie Magnum after her 20-odd years of continued embezzlement in Norfolk, Virginia. Minnie might have been discovered much sooner if her employer had asked the simple question "why doesn't Minnie ever take a vaction or a day off?"

The remainder of this paper will be devoted to an examination of the methods and tools available to the Commanding Officer in the control of nonappropriated funds and the minimizing of <u>opportunity</u>, which is the third prerequisite to an embezzlement - the prerequisite which is largely under the control of the Commanding Officer.

CHAPTER II

CONTROL OF NONAPPROPRIATED FUNDS

"Internal control comprises the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies."[1]

Thus internal control involves much more than mere protection of assets through the prevention and detection of fraud. But, as pointed out previously, fraud in the administration of nonappropriated fund activities can be extremely embarrassing and harmful to the Commanding Officer and to the Navy, and for this reason the remaining discussion attempts to focus upon the fraud-prevention aspects of internal control.

"The organization structure and the delegation of responsibility and related authority are, without question, the prime essentials in control."[2] Lamperti and Thurston cite the following generally accepted principles of organization:

1. An organization should be built around main functions and not individuals or groups. The basic pattern should be tailor-made to the needs of the business.

2. Functions should be broken down so as to promote balance in the organization and avoid duplication, overlapping, neglect of essential

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[1]American Institute of Accountants, 1949, Bulletin on Internal Control, quoted in Cadmus and Child, Internal Control Against Fraud and Waste, p. 4.

[2]Bradford Cadmus and Arthur J.E. Child, Internal Control Against Fraud and Waste, Prentice-Hall, Inc., New York, 1953, p. 15.

functions, or overemphasis on any one function to the detriment of another. No function should be assigned to more than one independent unit.

3. Definite and clear-cut responsibilities with commensurate authority should be assigned to each executive.

4. Delegation of authority should be explicit and placed close to the point at which action occurs.

5. Line functions should be separated from staff, with the latter a service and advisory activity. Channels of command must not be violated by staff units.

6. Each executive should have a proper span of supervision, usually ranging from a minimum of three to a maximum of seven major subordinates reporting to him.

7. Every employe should know definitely to whom he reports and who reports to him. No one should report to more than one line superior.

8. Organizational structure should be kept as simple as possible. The number of levels of authority should be kept at a minimum.

9. Provision should be made for the coordination of related activitites.

10. The organization should be flexible, capable of adjustment to changing business conditions. The plan should be adaptable to expansion or contraction.

11. Each executive should be permitted to exercise the maximum initiative within the limits of his delegated authority.

12. Organization charts and manuals must be kept current.[1]

A sound organization structure enables the placement of individuals where they are best fitted, which in itself is an important beginning for internal control. A sound organization structure must also include definite delegation of authority and responsibility, such that management can pinpoint responsibility within the organization. It provides for separation of custodial or operational responsibility from the accounting

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[1]Frank A. Lamperti and John B. Thurston, Internal Auditing for Management, Prentice-Hall, Inc., New York, 1953, p. 22.

therefore, thereby preventing one individual from having complete control of a transaction from beginning to end.

Closely associated with the organization structure is the selection of individuals to perform the various functions within the organization. In a way, the prevention of fraud and inefficiency begins with such selection and hiring of employes. Prospective employes should be carefully interviewed and screened, and their references checked. The hiring of a known fraud into a position of trust would be most embarrassing and costly, but it has happened, and can happen if the applicant's past record of employment is not investigated.[1]

Accounting Instructions for Open and Closed Messes Ashore,[2] as well as other similar publications, give recognition to the importance of organization structure in control, stressing the importance of the automatic checks and balances provided by proper segregation of records and functions. These accounting instructions also recognize that

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[1] "A 42-year old strawberry blond was able to perpetrate 15 different thefts from 15 different department stores in New York, Newark, Detroit, Pittsburgh, and half a dozen other cities. She would hold each job only several days, just long enough to find a time shortly before closing, when receipts were near the day's peak. Then she would slip out with the cash register's contents. An investigation of the employment record of this woman would have prevented these losses. Her total thefts amounted to $75,000.

In investigating all new employes a complete accounting should be required of the employment record. An inquiry form should be sent each employer worked for during the last 5 or 10-year period. Many concerns have found the cost of mercantile credit reports to be negligable compared with the results obtained therefrom. Also, many companies are finding aptitude tests an invaluable aid in weeding out those employes who do not fit and who are more apt to succumb to the temptation of stealing when the opportunity is presented." ( George A. Conner, Vice President, Fidelity and Deposit Company of Maryland, The Cost of Fraud, Best's Insurance News, Fire & Casualty Edition, May 1956, p. 24.)

[2] Office of the Comptroller, Department of the Navy, Accounting Systems for Open and Closed Messes Ashore, NAVEXOS P-1032, Revised 30 June 1954.

the organization structure will of necessity vary in accordance with the magnitude of the operations. It might be added that the permanent staffing of many nonappropriated fund activities must of necessity be severely limited due to austere personnel allowances, making strict adherence to sound principles of organizational control very difficult. Shortages of officer personnel, particularly on board small ships and stations, often make it necessary for an officer, who already has important primary military duties, to assume the management of a nonappropriated fund activity on a collateral basis. The resulting dilution of the officer's attention often results unfavorably for the nonappropriated fund activity, because, after all, his military duties must have priority. In such small activities it is mandatory that the Commanding Officer exercise particular care to ensure that the assets of the fund are properly safeguarded. There are several things he can do in this respect: First, he can assign such collateral duties to an individual whose talents best suit him therefor, and whose military duties are less pressing than other prospective appointees; second, he can appoint other talented people to act as part-time assistants in carrying out various functions, such as cashier, custody of petty cash, custody of supplies and equipment, and bookkeeping; third, he can devote particular attention to these activities during his routine inspections; and fourth, he can ensure that a strong well-trained organization is provided for frequent audits. The point is this: it is the responsibility of the Commanding Officer to maintain a system of internal control which will protect the assets of the fund, check the accuracy of the accounting records, and provide for an efficient organization. Lack of personnel and

shortages of trained personnel are probably valid reasons for loose control, but they certainly are not valid excuses, and would not be accepted as such in the event a defalcation or other loss occurred.

At this point it might be of interest to introduce a case study which illustrates possible results of loose control due to concentration of functions in one person.[1]

At Station X is a small Commissioned Officers' Mess (Open), which operates a bar and package store. Meal service is not provided, due to the small size of the station. Until recently, Lieutenant Y was assigned primary duty as officer in charge. This was essentially a one-man operation, inasmuch as the only full-time employe was a civilian barman. An enlisted man was assigned as bookkeeper and office assistant on a part-time basis. Since Lieutenant Y handled all business papers, he exercised control of the books, for all practical purposes. In addition to his duties as general manager of the mess, he operated the package store and acted as cashier. He made all bank deposits, reconciled bank statements, and prepared the monthly financial statements. The bar barely made expenses on most days, but the package store did a large volume of business and normally "carried" the club. Lieutenant Y was 34 years of age, was married, and had two children. He was well liked, had a good military record, and enjoyed the complete confidence of the Commanding Officer. Routine audits had consistently indicated

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[1]This case study is a composite, consisting of several circumstances of loose control and fraud in connection with Officers' Club activities which were actually observed by the writer during his naval service. The untimely demise of the club officer is a device to bring the fraud and inefficient operation to light, and did not actually happen.

that the mess was well run, and in accordance with established procedures.

Lieutenant Y was recently killed in an automobile accident. The Commanding Officer appointed a successor, and directed an audit of the mess by a newly-constituted audit board, whose members had not previously participated in an audit of the mess. The audit board found Lieutenant Y's post-dated check for $300 in the cash box, as well as three other post-dated checks signed by officers attached to the station, aggregating $550. The audit board, upon taking an inventory of the package store and the adjoining storeroom, found a shortage of approximately $600, represented by 12 cases of empty liquor bottles.[1] The audit board questioned the members of the regular inventory board as to their method of taking inventory in the past. The members of the regular inventory board reluctantly revealed that they had allowed the Club Officer to point out liquor cases on the shelves and call out the contents of each case. At no time had they removed cases from the shelves to verify their contents. The remainder of the audit was conducted carefully, in accordance with established procedures, but failed to reveal any discrepancies other than the inventory shortage and the post-dated checks. Lieutenant Z, who had verified Lieutenant Y's cash incident to previous audits, revealed that on each of five or six previous occasions he had noted such post-dated checks in varying amounts, but had not reported them. His reason for not doing so was that on the first such occasion,

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[1]This inventory fraud is reminiscent of the case cited by George A. Conner in The Cost of Fraud, Best's Insurance News, Fire and Casualty Edition, May 1956, p. 24:

> A loss of 28 refrigerators, 14 gas ranges, and a number of other bulky pieces of household equipment was sustained by a department store, even through a careful inventory of all merchandise was maintained. The loss remained undiscovered because the defaulter nailed the empty crates to the floor so that the checkers would think that they were still full.

and on each subsequent occasion, one of the post-dated checks in Lieutenant Y's cash box was signed by one of Lieutenant Z's superiors, inferring that discretion was the better part of valor in this instance.

During subsequent operation of the club under the new management, Lieutenant Y's personal post-dated check was returned marked "no account." The remaining post-dated checks cleared, of course.

The new manager, in checking the operation of the bar, noted an increase in bar sales over the level prevailing during Lieutenant Y's tenure. This level of bar sales continued for about two months, then gradually reduced to approximately the former level. A surprise inspection of the bar stock revealed several liquor bottles which did not have the prescribed decal attached, indicating the obvious truth that the barman had been selling his own liquor at the bar, and neglecting to ring up sales on the cash register.

In the foregoing case it would appear that the Commanding Officer should consider himself fortunate that the mess officer's defalcation was limited to $900. Since he had virtual control of the accounting records, and he had complete control of cash and inventories, he was in an excellent position to embezzle much larger sums through manipulation of cash receipts and cash disbursements. This organization is typical of many small businesses, in which only one person may combine all the various functions of bookkeeping, disbursement of funds, and the custody of various assets. In such a small business, the hiring of sufficient personnel to provide for adequate internal control is not economically feasible, and therefore the owner or manager must perform

many duties of the internal auditor to compensate for the lack of other internal controls. However, in the case of a nonappropriated fund activity, the Commanding Officer has manpower resources with which he can achieve internal control, as pointed out previously. He can assign personnel from his on-board complement to assist in certain functions, such that there is at least some separation of custodianship and operations from the accounting therefor. And certainly when staffing is limited the Commanding Officer must give these activities his particular attention to ensure that the required internal audit functions are carried out.

The above discussion has been confined largely to Commissioned Officers' Messes. The same principles generally apply to other non-appropriated funds such as Recreation Funds. The Navy Special Services Manual outlines the following duties of the Special Services Officer:

> The Special Services Officer will normally be responsible for the following:
>
> (a) Athletics, shows, dances, all-hands parties, movies, libraries, station newspapers, games and associated equipment, C.P.O. Messes and Enlisted Mens' Clubs and similar activites . . . Generally, the Special Services Officer will also act as custodian of the Recreation Fund. However, where the Commanding Officer deems it advisable, he may detail, in writing, an officer other than the Special Service Officer to act as custodian of the Recreation Fund.[1]

Thus we have in the standard organization book for Recreation Funds a provision which "generally" gives the Special Services Officer custodial and operational responsibilities coupled with accounting therefor - an inherent weakness of organization which must be countered by strengthened internal audit as well as increased personal vigilance

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[1] NAVPERS 15869, Special Services Manual, Department of the Navy, Bureau of Naval Personnel, Washington, D.C., p. 5.

and attention by the Commanding Officer. And he can well give consideration to detailing an officer other than the Special Services Officer to act as Custodian of the fund, as authorized by the Special Services Manual.

All ships and stations have a comprehensive system of internal directives which specify the methods and procedures to be followed in executing the many tasks assigned. Nonappropriated Fund activities should not be neglected in this area, because the detailed specification of methods and procedures is an important means of internal control. Basic policies, regulations, and procedures for the operation of nonappropriated fund activities are contained in various Department of the Navy directives, such as the Manual for Commissioned Officers' Messes Ashore.[1] It is emphasized that these directives are basic, and require local amplification and modification in many respects. Methods and procedures should be reduced to writing, and should cover in detail every operation performed within the activity concerned. Once a procedure has been adopted, variations should be kept to a minimum in order to enable management to concentrate on deviations.

At this point a discussion of some procedures in historically troublesome areas may be in order. First, let us examine the procedures which should be followed by a mess manager in controlling his bar operations. Perhaps the reader is familiar with the story of the bar proprietor who, in response to an inquiry about salary, informed a prospective employe that the pay was "_____ dollars a week plus what you can steal." This illustrates, albeit crudely, the difficulty of

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[1] NAVPERS 15847, Manual for Commissioned Officers' Messes Ashore, 1955, Department of the Navy, Bureau of Naval Personnel, Washington, D. C.

bar control, and the lethargy with which some bar managers view it.

Needless to say, the bar procedure should prohibit the barman from using any bar stock which does not have the U.S. Navy decal attached, which provision was violated by the barman in the previous case study. The procedure whould prescribe the maximum and minimum limits of each variety of bar stock, and should require the barman to submit a requisition to the stockroom clerk for the purpose of drawing replacement stock. It should set forth standard recipes for each type drink, and should require the use of automatic pourers attached to the more popular brands, rather than reliance upon "seaman's eye." Inventory of bar stock should be taken daily or at least weekly, by the mess manager or a responsible authority other than the barman, and the ratio of bar costs to sales calculated. The ratio of bar costs to sales (bar cost percentage) should remain fairly constant for a given bar, and any material fluctuation should be investigated thoroughly. Historical records of daily gross sales and bar profit should be similarly maintained, and unusual variances should be thoroughly investigated. Other details such as the following should be covered:

1. Many Officers' Messes allow the manager an allowance for entertainment for the purpose of maintaining good public relations. This is generally considered to be a good practice. However, it must be carefully controlled. Written procedure instructions should place monetary and other appropriate limitations on such an allowance, and should require that charges against the entertainment allowance be recorded as administrative expenses. To this end, the manager, upon receiving beverage service properly chargeable to his entertainment

allowance, should sign the receipt, and the barman should ring it up on the cash register as a cash receipt. The barman should retain the signed register receipt and turn it in with his cash. If the manager's entertainment allowance is not closely controlled the barman may recognize the opportunity afforded him, and succumb to temptation.

2. Working hours and shifts should be rotated as feasible, in order to discourage the development of cliques for collusion, and all employes should be required to take regular vacations.

3. Bar stocks must be kept out of easy reach of other employes and patrons.

4. A control measure must be adopted to guard against fraud in connection with cash-register tape. In some types of cash register it is possible to retard the tape to an unused portion and record fictitious credits, then return the tape to its proper position for recording the next legitimate transaction, such that the total sales will read less than the actual cash receipts by an amount equal to the fictitious credit applied. The same fraud can be perpetrated with an ordinary adding machine tape, of course. "Accidentally" tearing the tape at a convenient location might also serve to hide a fraudulant transaction.

6. Leakage, spoilage, and breakage should be supported by visual evidence. As an example, bar procedure should require that if the barman breaks a bottle accidentally he will immediately notify the manager, who will verify that the breakage actually occurred as claimed. Such breakage should be supported by a suitable expenditure paper approved by the manager, and any repititions should be viewed with suspicion. Storeroom clerks have been known to "accidentally" drop a case of alleged spirits on the floor, breaking "12" bottles, whereas actually the case contained only

1 or 2 full bottles and 10 or 11 empties. Such breakages should be examined to ensure that U.S. tax seals are intact.

7. Requisitions for bar replacement stock should be accompanied by an equal number of empty bottles, which should then be destroyed by the manager or a responsible person other than the barman. Empties should never be taken directly to the garbage.

8. Family groups should not be employed.

9. Employes should be denied the privilege of drinking on the premises, regardless of whether or not they pay the regular bar price therefor.

10. Beverages should not be dispensed on unauthorized credit, or "on the house."

11. Standard bar prices should be posted, and should be charged all patrons. Favored patrons should not be under charged nor be served supercharged drinks.

12. Cash register should be in plain view so that the patron can easily see the amount which is rung up thereon.

13. Special control provisions must be prescribed in the event social periods or "happy hours" are held during which reduced prices prevail.

The above is not intended to be an exhaustive list of points which must be covered in the instructions governing the operation of a bar. Actually, beverage operations experience theft in forms which defy the imagination. The problem is further complicated by the fact that theft of liquor is often viewed as a prank or game, rather than dishonesty.

Another important trouble-spot in nonappropriated fund activities is food service. In this area, as in beverage operations, the opportunities for theft and pilferage are considerable, unless procedures and controls are skillfully developed and rigidly applied. The basic procedures to be followed in the purchase and issue of merchandise, supplies, and equipment are contained in NAVEXOS P-1032.[1] These procedures are fairly standard for businesses in general, and generally adhere to the principles recommended in many standard textbooks on internal control. Since these procedures are exceedingly important, they have been reproduced, as follows:

"1210 PURCHASES AND ISSUES

1. PURCHASE OF MERCHANDISE, SUPPLIES, AND EQUIPMENT

a. Purchase Order

(1) Basic Requirement. Purchase Order (NavCompt Form 739) will be issued for all purchases of merchandise, supplies, and equipment made from commercial concerns except for purchases made from the petty cash fund in nominal amounts. In certain cases, such as for small purchases of office supplies and telephone orders for deliveries on the same day, when it may not be practicable to furnish the dealer with a formal purchase order, the regular purchase order form will be used, but "Confirmation" will be typed or stamped thereon. A weekly or monthly blanket purchase order will be written to cover daily deliveries of dairy or bakery products.

(2) Preparation. The NavCompt Form 739 is produced in sets containing an original and three multi-colored copies. The name and address of the mess will be inserted in the space provided therefor and will be pre-numbered either by typing, stamping, or overprinting. Sufficient forms will be pre-numbered in advance by the treasurer or his designated representative and each number accounted for. All orders will be signed by the treasurer or his designated representative. Designation to sign purchase documents will be authorized in writing.

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[1]NAVEXOS P-1032, Revised 30 June 1954, Accounting Systems for Open and Closed Messes Ashore, Office of the Comptroller, Navy Department, Washington, D. C.

(3) Distribution of Copies. The original will be sent to the dealer. The blue copy will be forwarded to the bookkeeper (or other person designated by the treasurer). The green and yellow copies will be forwarded to the activity designated to receive the merchandise.

(4) Office File. The bookkeeper (or other person designated by the treasurer) will maintain an "Open Order File" of the blue copies in numerical sequence.

(5) Receiving Activity File. The receiving or other activity concern will maintain an "Open Order File" in which both the green and yellow copies will be filed by dealer's name.

b. Request for Issue or Turn-in

(1) Basic Requirement. A request for Issue or Turn-in (DD Form 1150) will be ussued for purchases made from supply activities.

(2) Preparation. All orders will be prepared in quadruplicate and be numbered in numerical sequence. Al orders will be signed by the treasurer or his designated representative. Designation to sign orders will be authorized in writing.

(3) Distribution of Copies. The original will be sent to the supply activity, a copy to the bookkeeper (or other person designated by the treasurer), and two copies to the activity designated to receive the merchandise.

(4) Office File. The bookkeeper (or other person designated by the treasurer) will maintain an "Open Order File" in numerical sequence.

(5) Receiving Activity File. The receiving activity or other activity concerned will maintain an "Open Order File" in which both copies will be filed together.

2. RECEIPT OF MERCHANDISE, SUPPLIES, AND EQUIPMENT

a. Procedure for Receiving Activity. When delivery is made, the receiver will withdraw the copies of the applicable order from the "Open Order File", inspect the material received, and, if satisfactory, certify on both copies of the order "Received (date), found satisfactory, and accepted." Any variance between the quantity or price on the order and the dealer's delivery ticket or invoice will be called to the attention of the treasurer or his designated representative unless written authority has been granted by the treasurer or his designated representative to the receiving activity to accept such variances from the original order. Subject to the approval of the treasurer or his designated representative, appropriate corrections will be made on all copies of the order. The quantity received and the price indicated on

the order will be recorded on the Property and Stock Record. It is desirable that a person other than the receiving or issuing clerks be designated to maintain property and stock records. One copy (green copy of NavCompt Form 739), together with the dealer's delivery slips received with the goods, will be forwarded to the bookkeeper. One copy (yellow copy of NavCompt Form 739) will be retained by the receiving activity for ready reference in regard to merchandise received.

b. Blanket Purchase Orders. When a blanket purchase order is used daily deliveries will be recorded on the reverse of both the green and yellow copies of the order during the period covered. At the end of the period the green copy will be sent to the bookkeeper. The dealer's delivery slips will be sent to the bookkeeper daily. As dairy and bakery products are consumed daily, no record need be made on the Property and Stock Record.

c. Procedure for the Bookkeeper. The bookkeeper, upon receipt of the green copy of the order from the receiver, will withdraw the corresponding blue copy of the same order from the "Open Order File" and compare both copies with the dealer's delivery slip. If found to be in agreement, both copies together with the dealer's delivery slip or invoice will either be stapled together or attached to an Expenditure Voucher (NavCompt Form 740) and filed in a "Pending Receipt of Dealer's Bill" file. Any differences will be brought to the attention of the treasurer.

d. Expenditure Voucher. This form may be used for recording all purchases and other expense items when a voucher system is desirable. When invoices are payable separately under discount, a separate voucher will be prepared for each invoice or bill. One voucher will be prepared for each dealer when all invoices or bills for that dealer will be paid by one check. All supporting papers will be attached thereto. The invoices or bills will be recorded individually on the voucher as received.

3. Processing of Dealers' Bills. Upon receipt of the dealer's bill or supply activity's invoice, the bookkeeper will either place it in file or attach it to the voucher with the copy of the order pending receipt of the material, or will withdraw the orders or voucher from the "Pending Receipt of Dealer's Bill" file and verify the dealer's bill or invoice with the quantity ordered and received, unit price, and extension and terms of payment. After the dealer's bill or supply invoice and both copies of the order have been matched, the bookkeeper will indicate in writing on the bill that it is correct; will initial the bill; and prepare a check and submit the check with the orders or voucher, with all documents attached, to the treasurer or his designated representative for signature. Any differences will be called to the attention of the treasurer or his designated representative. No dealer's bill or supply invoice will be paid unless covered by an order on which appears a certification of receipt and acceptance signed by the designated representative of the receiving activity concerned. When several purchases are made during any one month from the same dealer and separate payment for each purchase is not required, payment may be made monthly by the

issuance of one check. All related orders and supporting papers, including the dealer's monthly statement, if received, will be submitted with the check to the treasurer or his designated representative for signature.

4. ISSUES

(a) Basic Requirement. Requisitions (Procured locally) will be prepared for all stock issued from a central storeroom or transferred from one activity to another.

(b) Preparation. Requisitions will be prepared in triplicate and be prenumbered serially. All requisitions will be signed by the person in charge of the requisitioning activity.

(c) Distribution of Copies. The original and second copy of the requisition will be sent to the central storeroom or transferring activity until the stock is received.

(d) Central Storeroom or Transferring Activity. The person issuing and the person receiving the stock will sign and date the original and second copy of the requisition. The original will be sent with the stock, and the second copy will be filed.

(e) Requisitioning Activity. The stock received will be checked with the original requisition which will then be dated, signed, and sent to the bookkeeper. After the stock has been received, the third copy of the requisition may be destroyed.

(f) Bookkeeper. The bookkeeper will use the original requisition for posting purposes. All issues will be recorded on property and stock records. After posting, the original will be filed in an "Issued" file.

If the preceding procedures are followed without exception, fraud by single individuals will probably be minimized. But the protection afforded by a double-entry bookkeeping system and good internal controls should not be over-emphasized, particularly if the controls cease to be effective beyond the point of issue of supplies and materials. Even with a standard double-entry bookkeeping system, and with the division of responsibilities and functions as outlined above, collusion among the internal staff, or between an outsider and one or more of the internal staff, would be extremely difficult to detect - in fact under

many circumstances would almost defy detection. The following case serves to illustrate:

> At one mess it was found that the iceman was working with a cook. The iceman regularly delivered his bagful of crushed ice and returned nonchalantly to his delivery truck, tossed the bag into the back of the truck, and drove off. Repeated losses in inventory convinced the manager that food was being stolen, but it took him a long time to find that the iceman's bag was always full. It was full of ice when he entered the kitchen, and it was full of hams and other choice food items when he tossed it into his truck and drove off. The iceman later sold his loot and split the proceeds with the cook.[1]

In another case, which the writer learned of informally, the receiving clerk (who also had charge of the walk-in refrigerators) was in collusion with the galley chef and a regular supplier of meats. U.S. grade "Choice" meats were invariably ordered and paid for by the mess treasurer, but the patrons were served U.S. grade "Good" steaks. The latter must have been treated liberally with meat tenderizer, for the patrons did not complain. The fraud was discovered after the Commanding Officer, on a routine inspection of the Officers' Mess, noted some "Good" beef hanging in the reefer, and questioned the manager about it.

In another case, which the writer also learned of informally, a treasurer of a closed officers' mess was perplexed by the excessive consumption of sugar by the mess members. 200 mess members apparently accounted for 100 pounds of sugar daily, or one-half pound per person. He subsequently learned that the baker had an interest in a bakery business in the city, and was supplying a portion of the sugar requirements at the expense of the closed mess.

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[1] NAVPERS 15870, Operating Manual for Navy Messes and Clubs Ashore, Depart. of the Navy, Bureau of Naval Personnel, Washington 25, D.C. p. 43.

The frauds illustrated by the foregoing cases admittedly are of a minor nature. But if long-continued they would eventually amount to a very considerable sum of money, and would necessarily result in higher prices for patrons of the mess. The fraud cases immediately preceding also point up the obvious requirement that controls be developed and applied to the handling of merchandise and materials <u>after</u> they are issued by the stockroom clerk. In the case of beverage service, the required controls have already been discussed briefly. The control of food service from the issue storeroom to the customer is extremely complex, and can only be touched upon in this discussion. Such controls as the maintenance of daily food cost records, food production planning, standardized recipes and guides, portion control, and cost control in food preparation may be employed depending upon the size of the operation. Specific instructions from higher authority in this area are rather sketchy, and much is left to the discretion of the manager (and the Commanding Officer.) NAVEXOS P-1032 outlines the essentials of a food cost control system as follows:

2. FOOD COST CONTROL

a. Essentials of a Food Cost Control System. Although the procedures recommended herin are optional, some type of food cost control system is required. When determining a practical system for the individual mess, the following essentials should be considered:

> (1) A food cost control system must be practical; that is, it must not interfere with the working routine of the galley and its cost must be considerably less than the saving it effects;
>
> (2) It must give sufficient detailed information on which to base corrective measures.

b. Food, the Largest Item of Cost. Food is usually the largest item of operating cost in any food sales activity and at the same time it is the item subject to the greatest fluctuation. Even with constant sales, menu differences, overproduction and wastage may cause the cost of food to increase suddenly. The well-developed food cost control system calls to the attention of the management increasing costs from day to day and provides the means whereby a serious operation loss may be averted. It may also be used to discover in exactly what type of food sales the difficulty lies.

c. Daily Inventories Not Required. A daily inventory of food on hand in the galley is not required, provided this quantity is kept at the irreducible minimum. Only sufficient food for each day's needs should be requisitioned from the storerooms or storage refrigerators, any unused food should be returned and the storerooms or storage refrigerators charged. The galley has a certain working inventory of staples on hand at all times, but if this is maintained at a reasonably constant level, food cost percentages will not be materially affected.

d. Determination of Daily Food Costs. Therefore daily food costs may be easily determined by using the following information:

(1) costs of direct purchases (perishables delivered daily to the galley);

(2) costs of transfers from storerooms (daily requisitions)

(3) amount of sales (total of cash register readings, charge slips and coupons collected);

The total of items 1 and 2 divided by item 3 is the Daily Food Cost Percentage.

e. Normal Distribution of Food Cost. The distribution of food cost shown below is generally considered to be a normal one. However, there will be variations depending upon such factors as climate and type of menu. The prime purpose of the analysis of food received is to determine what percentages are normal for a particular mess and to make possible an immediate investigation of any marked variations from that normal. This investigation should begin with a further breakdown of meats, groceries, dairy and bakery products (for example, for dairy products: eggs, butter,milk and cream and ice cream). The comparison of past with present experience in the sub-divisision concerned will quickly show the location of the shortages. Next, the cause should be found by close observation and detailed controls were needed.

| | | Food Dollar | |
|---|---|---|---|
| Meats | Meat | 23.0% | 42% |
| | Poultry | 10.0 | |
| | Seafood | 9.0 | |
| Groceries | Produce | 23.0 | 33% |
| | Staples and Canned Goods | 8.0 | |
| | Coffee and Tea | 2.0 | |
| Dairy | Eggs | 4.5 | 20% |
| | Butter | 6.5 | |
| | Milk and Cream | 5.0 | |
| | Ice Cream | 4.0 | |
| Bakery | | 5.0 | 5% |
| | | 100.0% | 100% [1] |

Several important works on food service and controls in connection therewith are currently available and should be consulted by the mess manager.[2]

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[1] NAVEXOS P-1032, Accounting Systems for Open and Closed Messes Ashore, Office of the Comptroller, Department of the Navy, Washington, D.C., p. 1-25.

[2] Brodner, Carlson, and Maschal, Profitable Food and Beverage Operation, Ahrens Publishing Company, New York: 1951, is an excellent reference on the management of food service.

# CHAPTER III

## INTERNAL AUDIT OF NONAPPROPRIATED FUNDS

The Secretary of the Navy has vested in the Comptroller of the Navy both the authority and the responsibility for developing and conducting* an "internal audit" program throughout the navy. Specifically, the Comptroller of the Navy is required to:

(1) Develop audit principles, policies and procedures and exercise technical supervision of audit operations in and throughout the Department of the Navy.

(2) Perform audits and examinations, as required, of systems, procedures, records, and documents pertaining to the obligation of and expenditure of appropriated funds, property accounting, sales and reimbursements and of non-appropriated funds.

(3) Coordinate with the Naval Inspector General, to the fullest extent feasible, audits and examinations of field activities.

(4) Coordinate Navy audit programs, as required, with the Comptroller of the Department of Defense, the General Accounting Office and other government agencies.[1]

For any of the various nonappropriated funds, the scope of the audit program at field and departmental level is outlined by the Comptroller of the Navy as follows:

The auditor, by selective checks and such detailed verifications as he deems necessary in any of the fiscal areas affected, will:

(1) Ascertain the authority for the fund; verify the accuracy and propriety of accounting for receipts and disbursements; appraise controls maintained over receipts and collections; ascertain that transactions are in accordance with prescribed policies and procedures.

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[1] Office of the Comptroller of the Navy, Internal Auditing - Principles, Policies, Minimum Standards and Objectives, Department of the Navy, Washington, D. C. May 1951, p. 1.

depending on the extent to which the fund has been audited by independent public accountants.

(2) Verify assets, liabilities, and contingencies.

(3) Evaluate adequacy of accounting records.

(4) Determine that concession agreements or contracts have been negotiated in accordance with established authority, and that appropriate disposition has been made of income derived therefrom.

(5) Ascertain that minutes of meetings are maintained and filed, and that adopted resolutions relating to fiscal administration and management of funds are being observed.

(6) Determine that funds of transferred or deactivated units have been properly computed, transferred, or otherwise accounted for.

(7) Check solvency of funds.[1]

Open and Closed Messes Ashore will be used as an example to trace the internal audit function as it generally applies in the broad field of non-appropriated funds. In the case of Open and Closed Messes Ashore the internal audit function is performed at four administrative levels, as follows: (1) The Comptroller of the Navy; (2) The Bureau of Naval Personnel; (3) The Cognizant Authority;[2] and (4) The Commanding Officer.

The Comptroller of the Navy, in collaboration with the Chief of Naval Personnel and the Commandant of the Marine Corps, has promulgated instructions governing the system of internal controls and accounting procedures applicable to navy and marine corps mess funds.[3] He also

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[1] _Op. cit._, p. 18.

[2] "The Commandants of Naval Districts and River Commands, Chiefs of Air Functional Training Commands, Force and Area Commanders are designated "Cognizant Authorities" for the purpose of administering Commissioned Officers' Messes ashore within their commands." (NAVPERS 15847, p. 2)

[3] Office of the Comptroller of the Navy, _Accounting Systems for Open and Closed Messes Ashore_ (short title: NAVEXOS P-1032), Department of the Navy, Washington, D. C. 30 June, 1954.

has developed detailed uniform auditing procedures for use of Audit and Inventory Boards, and guidance for cognizant authorities in conducting inspections of messes and clubs, which are contained in NAVPERS 15047.[1] Representatives of the Comptroller of the Navy may perform audits of nonappropriated funds at the field level at the discretion of the Comptroller. Such audits in general are not complete detailed audits except when unusual problems are involved, or when a thorough examination and audit of financial and accounting operations seems desirable. Normally, audits of nonappropriated funds at the field level are not conducted by the Comptroller of the Navy except in conformance with the principle of management by exception, or in cases where the lower echelons are unable to cope with a given situation, or request advice and assistance.

The Chief of Naval Personnel has the responsibility for technical control of Commissioned Officers' Messes. He issues instructions governing the administration of messes, requires the submission of financial reports and reports of inspection, and provides supplementary guidance and technical assistance as appropriate and on request.

The cognizant authority is required to assure himself of the proper administration of all messes at stations within his command by at least one regular or one surprise inspection of each mess each fiscal year. The purpose of such inspections is two-fold: first, to assist the Commanding Officer and the mess treasurer in the proper

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[1]Bureau of Naval Personnel, Manual for Commissioned Officers' Messes Ashore, Department of the Navy, Washington, D. C., 1955.

fulfillment of the mission of the mess or club, and its efficient administration; and second, to serve the Chief of Naval Personnel in assuring that the mess or club is operated strictly in accordance with pertinent directives. During the course of each such inspection the cognizant authority conducts a limited audit of the mess, and offers advice and assistance where needed in accounting, auditing, and internal controls. The scope of his inspection will depend in large measure upon his impression of the thoroughness and adequacy of the regular monthly audits conducted by the station audit board.

The Commanding Officer is required to submit a monthly financial statement, and to assure himself, through monthly internal audit, that the mess is properly administered. He issues such supplementary instructions as he deems necessary.

The audit instructions contained in NAVPERS 15347 in effect constitute a comprehensive internal audit manual, and are in consonance with Lamperti's concept of the nature of internal auditing:

> Internal auditing is a series of processes and techniques through which an organization's own employes ascertain for the management, by means of first-hand, on-the-job observation, whether (a) established management controls are adequate and effectively maintained; (b) records and reports - financial, accounting and otherwise - reflect actual operations and results accurately and promptly; and (c) each division, department, or other unit is carrying out the plans, policies, and procedures for which it is reponsible.[1]

The audit instructions include detailed audit check lists for use by the audit board. These check lists provide for a review of the system of internal control as well as detailed audit. The check lists for the review of the system of internal control are in the form

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[1]Frank A. Lamperti and John B. Thurston, Internal Auditing for Management, Prentice-Hall, Inc., New York: 1953, p. 163.

of questions, such that a "no" answer would indicate weak or poor internal control, and would require explanation. The check list for internal control, is lengthy, but because of its importance it is reproduced below, with the writer's footnoted comments where appropriate.

REVIEW OF THE SYSTEM OF INTERNAL CONTROL

(a) Petty Cash Fund.

(1) Is the responsibility for the fund vested in one person only?[1]

(2) Is the custodian independent of the employe handling collections from patrons and other receipts? [2]

(3) Are petty cash vouchers prenumbered, prepared in indelible pencil, signed by the payee, and approved?[3]

(4) Are vouchers and attachments marked or stamped "Paid" to preclude re-use?[4]

(5) Is the cashing of personal checks from this fund prohibited?[5]

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[1]Only one person should be responsible for the petty cash fund, else a fraudulent transaction could be blamed on another person who also has access to the fund).

[2]If the custodian of petty cash is also the custodian of another cash fund, or is the cashier, or has access to the accounting records, the opportunity exists for fraudulent manipulations of transactions which clear through the fund).

[3]If so, this reduces the possibility of introducing fraudulent vouchers, or raising the amounts or otherwise fraudulently altering authentic vouchers).

[4]If a paid voucher were not properly canceled, it could be used again merely by altering the date. Vouchers should be canceled at the time a check is issued for the purpose of reimbursing the petty cash fund).

[5]The basic purpose of a petty cash fund is to facilitate disbursements of sums of money which are too small to justify issuing checks. This fund should be kept as small as practicable, and should not be used as a check-cashing facility).

(6) Is the use of this fund limited to small expenses of an emergency nature which could not be paid by check?

(7) Are checks for reimbursement made out to the order of "Petty Cash Fund?"[1]

(b) Change Funds

(1) Are the amounts of change funds authorized?[2]

(2) Are the funds checked by surprise counts made by the Mess Treasurer?

(3) Are proper physical safeguards and facilities employed to protect the change funds?[3]

(4) Are the amounts of the change funds reasonable?

(c) Cash Receipts

(1) Are daily receipts kept separate from the petty cash fund?

(2) Are cash receipts deposited intact and without delay?[4]

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[1]As with all cash funds, the petty cash fund should be inspected frequently at unannounced times by the manager of other responsible person, to minimize petty embezzlement and to ensure that the fund is not being used as a source of unauthorized advances).

[2]The amount of each change fund should be fixed, and each such fund should be authorized in writing by the manager).

[3]Each cashier should have a metal cash box in which his change fund is locked and stowed in a safe for overnight safekeeping.

[4]"The practice of allowing cash receipts to accumulate for several days and of permitting disbursements to be made directly from cash should not be tolerated. Both of these practices present too many opportunities for fraudulent manipulation by employes. All receipts of cash should be deposited intact, not less frequently than once a day. The following advantages accrue from prompt depositing of cash: (1) it reduces the risk of large theft losses and the accompanying expense of theft insurance; (2) it reduces opportunities for employe peculation through manipulation of records; (3) it furnishes a prompt and closer check on individual cashiers by localizing responsibility." (Lillian Doris, Editor, Corporate Treasurer's and Controller's Handbook, Prentice-Hall, Inc., New York: 1950, p. 644).

(3) Are bank deposits certified by means of:

(a) Duplicate deposit slips stamped by the bank or
(b) Entries in the pass book?[1]

(4) Are cash receipts recorded by cash registers?[2]

(5) If so, are the machine totals checked by some one other than the cashier?[3]

(6) Are printed prenumbered receipt books used?[4]

(7) Are the daily totals and numerical sequence checked by some one other than the cashier?

(8) Are unused receipt books safeguarded?[5]

(9) Are the duties of the cashier entirely separate from the maintenance of the individual patrons' accounts?[6]

(10) Are cash overages and shortages shown on the daily activity reports and recorded on the books?

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[1]Some business firms use a triplicate deposit slip method, wherein the third copy of a deposit slip is mailed by the bank directly to the company. This constitutes an added safeguard against manipulation of deposit slips.

[2]Ringing up sales on cash registers, in plain view of the customer, deters underreporting of sales, and provides a tamper-proof cumulative total of sales, if properly used.

[3]The cashier should not have access to the reset mechanism.

[4]Receipt forms must be prenumbered, and must be accounted for in order to preclude the substitution of fraudulent receipts, in which the amount received is shown to be smaller than that actually received.

[5]If cashier has an unauthorized supply of unused receipts he could use some for the purpose of giving a receipt to the customer, could then pocket the cash and destroy duplicate copies of receipts.

[6]The cashier should have no access to bookkeeping records, nor should the cashier be permitted to originate any business paper which would be the basis for adjustments to the accounting records. If a cashier had access to the accounting records he could, for example, pocket the money received from a customer on account, credit the customer's account for the amount received, and enter an equal charge to an expense account, such as bad debts expense.

(11) Are checks returned by the bank for insufficient funds controlled and a follow-up maintained?

(12) Are the cash receipts properly safeguarded at all times?

(13) Are there proper safeguards over the storage and sale of coupon books?

(d) Cash Disbursements

(1) Are all disbursements, except those from petty cash, made by check?

(2) Are printed prenumbered checks used and kept under control?

(3) Are voided checks properly mutilated and held for inspection?

(4) Is the signing of checks in advance prohibited?

(5) Is the practice of drawing checks to "Cash" or "Bearer" prohibited?[1]

(6) Are checks prepared by someone other than the signer?

(7) Are checks presented for signature accompanied by approved invoices and evidence of receipt and acceptance of goods and services?[2]

(8) Are all invoices stamped or marked "Paid" to prevent re-use?

(9) Are bank reconciliations made monthly?[3]

(e) Accounts Receivable

(1) Are accounts receivable records maintained independently of cash receipts?[4]

(2) Are monthly statements checked by some one other than the accounts receivable bookkeeper before mailing?[5]

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[1]This practice is an open invitation for a dishonest employe to steal.

[2]Some person other than the signer of the check should sign the file copy of the check, thereby certifying that all supporting papers are in proper order.

[3]Signatures and endorsements on canceled checks should be examined for evidences of fraud. Deposit dates as shown by the bank statement should be compared with deposit dates shown by records of cash receipts.

[4]A common fraud consists of pocketing collections made from presumably uncollectible accounts.

[5]Checking and mailing should be under the control of someone other than the bookkeeper and cashier.

(3) Are delinquent accounts reviewed by the Mess Treasurer and referred to the proper authority?

(4) Are disputed items and bad debts written off properly controlled?[1]

(5) Are all charge sales slips numerically controlled?[2]

(f) <u>Consumable Property Inventories</u>

(1) Are perpetual inventory records maintained for the bulk storeroom on a current basis?

(2) Are such records controlled by an office clerk or other individual not responsible for the stockroom?

(3) Are perpetual records checked with the physical count?

(4) Are properly approved adjustments made to the perpetual records as a result of variances found in the physical count?

(5) Are surprise spot checks made to ascertain that the perpetual records are maintained currently and are in agreement with the stock on hand?

(6) Are designated persons held responsible for the control of the various consumable inventories?

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[1]Bad debts written off must first be carefully investigated to ensure that the customer involved did not in fact pay his account. Where bad debts are generated by "rubber" checks, such checks should be thoroughly investigated, and the identify of the signers thereof be definitely established. A common fraud occurs when a cashier prepares a check, signs a fictitious name, pockets the face amount in cash. If customers take exceptions to statements, or if statements are returned due to incorrect address, such exceptions must be communicated directly to some responsible person other than the cashier or accounts receivable bookkeeper.

[2]An employe who has access to cash receipts could substitute a fradulent charge sales slip for the desired amount of cash.

(7) Are all receipts of material accounted for my means of receiving reports?[1]

(8) Are all issues accounted for by means of signed requisitions?

(9) Are inventory sheets and summaries properly initialed by all persons participating in the count, the pricing, the extensions, and the footings?[2]

* (10) Is the stock on hand properly binned, safeguarded, and controlled?

(11) Are the inventories of stock on hand in excess of current needs?[3]

(g) Investments

(1) Are securities owned by the mess properly safeguarded?

(2) Are detailed records as to certificate number, maturity date, amount, etc., maintained by the accounting office?

(3) Are all purchases and sales of securities approved by the commanding officer?

(h) Other Assets

(1) Are adequate records maintained for prepaid items?

(2) Is there an established procedure for amortizing these prepaid items?

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[1]If possible, receiving reports should be prepered by a person other than the stockroom clerk or office personnel handling details of purchasing or related accounting records. Purchasing, receiving, and storage functions should be separated in order to minimize the risk of collusion between a vendor and employes.

[2]This question brings to mind a fraud case, which the writer learned of informally, concerning an obese destroyer supply officer and his ship's store clerk. The bulk storeroom was situated in a tiny compartment, the access to which was a manhole of about the same dimensions as the supply officer's girth. The supply officer was apparently dubious of his ability to pass through the manhole, for his practice was to stand in the compartment above while his ship's store clerk called out the inventory from within the storeroom. For many months the inventory which he called out included considerable merchandise which was not there. His fraud was uncovered when a new supply officer, who took his own inventories, reported to the ship.

[3]Excessive inventories are costly to maintain, and, in the case of foodstuffs, results in excessive spoilage and shrinkage.

(i) Accounts Payable

(1) Are detailed records of open accounts with vendors reconciled monthly with the general ledger control account?

(2) Are vendors' statements compared with the open balance in their accounts before payment?

(3) Are all unpaid invoices for goods or services included in the inventory recorded as liabilities for the period under review?

(4) Are invoices held in abeyance pending evidence of receipt and acceptance of goods or services?

(5) Are accounts settled promptly and advantage taken of cash discounts?

(j) Accrued and Other Liabilities

(1) Has provision been made for expenses incurred but not yet paid?

(2) Are there documents on file to support entries in these accounts?

(k) Sales and Other Income

(1) Are all sale prices governed by approved menus and standard price lists?

(2) Are all sales controlled by use of registers or other mechanical devices?

(3) Are all sales (cash and charge) slips prenumbered and properly controlled?

(4) Are sales slips arithmetically checked?[1]

(5) Are cash registers read at the end of each work shift and compared with the actual receipts?

(6) Is a comparison made monthly by the Mess Treasurer of the sales per cash register and the recorded receipts?

(7) Is there control maintained over the sale of garbage and scrap?[2]

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[1]A common fraud occurs when the sales clerk charges the customer more than the duplicate sales slips show, or underfoots the duplicate sales slip, pocketing the difference.

[2]This must be carefully controlled, as such sales are often consummated on a bargaining basis, and for cash.

(8) Are all concessions covered by written agreements?

(9) Is a mess employe present at clearance of vending and amusement machines to check the accuracy of the concessionaire's report?

(l) Purchases and Expenses

(1) Is the purchasing separate from the accounting, the receiving, and the issuing functions?

(2) Are all purchases (except small items purchased from petty cash) made by means of purchase orders?

(3) Are purchase order forms prenumbered?

(4) Is a copy of the purchase order given to the receiving department as authority to accept goods?

(5) Are all invoices approved by the Mess Treasurer or his designated representative?

(6) Is there a definite responsibility for checking invoices as to prices, extensions, and discount terms?

(7) Are all invoices for expenses properly supported and controlled?

(m) Payrolls

(1) Is the payroll approved by the Mess Treasurer before payment?

(2) Are the time reports of hours worked approved by the activity manager?

(3) Are all employes paid by check?

(4) Are payroll computations checked by some one other than the person who prepares the payroll?

(n) Nonconsumable Property (Furnishings and Equipment)

(1) Are the property records maintained on a current basis?

(2) Are purchases and dispositions approved?

(3) Are discrepancies between property records and physical inventories investigated and adjustments to the property records approved?

(4) Is adequate fire insurance carried on property owned by the the mess or club?

(c) Is there an up-to-date organization chart available which reasonably fixes the responsibilities of key employes?

NAVPERS 15347 also lists the detailed audit steps to be followed by the audit board. These are as follows:

(a) Cash on Hand-General

* (1) Control all cash and cash items to be counted.[1]

(2) Make count in presence of responsible individual(s).

(3) Obtain signature(s) of cash custodian(s) acknowleging return of all cash and cash items, upon completion of count.

(4) If the audit takes place subsequent to the closing date of the last audit period, reconcile count to the audit date.

(5) Ascertain that all cash funds (petty cash, change funds, check cashing, etc.) have been authorized.

(6) Determine if cash funds are properly safeguarded.

(b) Cash on Hand-Undeposited Receipts

(1) Count cash and checks on hand.

(2) List all currency, coin, and checks.[2]

(3) Trace all checks and currency to the Cash Receipts Journal and duplicate receipted deposit slips.[3]

(c) Cash on Hand- Imprest Petty Cash

(1) Count currency, coin, etc., and list on working paper

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[1]Control over all funds being counted is essential, in order to prevent transfers from one fund to another during the inventory. Shortages have been covered up by such transfers, particularly where one person is responsible for two or more funds.

[2]Checks in all funds should be inspected carefully for post-dating, or for old checks. The former, of course, are unauthorized loans, in effect, and the latter probably are being held as a favor.

[3]The auditor should be alert for checks received but not recorded in the cash book.

(2) Examine for approval and list expense vouchers held in fund.[1]

(3) In those cases wherein the petty cash custodian makes up a minor shortage at the time of the count, obtain written approval of such reimbursement from the Mess Treasurer.[2]

(4) Where improper or irregular items are disclosed at the time of the first count, make a later count and reconcilement to determine that subsequent receipts have not been used to cover deficiencies.

(5) Check the amount of the fund with the balance in the books.

(d) Cash on Hand- Change Funds

(1) Count all change funds.

(2) If a change fund has been issued before the audit board begins its count, contact the cash custodian, take register readings, count the cash, and reconcile to recorded sales plus the amount of the change fund.

(e) Cash in Bank

(1) Obtain the bank statements and canceled checks for the period to be audited.[3]

(2) Examine the bank statements for erasures or changes of any amounts shown thereon, and confirm changes with bank.

(3) Reconcile the bank balances per statement.

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[1]Vouchers should be carefully inspected to ensure that the totals have not been altered. To prevent alteration, vouchers should be typewritten or made out in ink or indelible pencil. Amounts should be written out in full.

[2]Small shortages, in themselves insignificant, may be indicative of more serious underlying faults.

[3]Common auditing practice requires the auditor to obtain directly from the bank the statement and canceled checks. If the employe involved has access to bank statements before the audit he has opportunity to alter the statement and to destroy any checks which might be evidence of fraud. If a dishonest employe has a confederate in the bank, he might obtain a supply of blank bank statements and prepare his own bank statements to conceal a fraud.

(4) Examine all canceled checks for approximately one week of the of the audit period and trace to Cash Disbursements Journal. Also:

(a) Compare nature of the check drawn with accounting distribution.

(b) Compare name of payee, amount and date of check with Cash Disbursements Journal.

(c) Compare endorsements with name of payee.[1]

(d) Investigate double endorsement where second endorsement is that of a person connected with the Mess or Club.[2]

(e) Investigate all checks (other than pay checks) made payable to bank or employees.[3]

(5) See that all checks are accounted for and that voided checks are mutilated and retained.

(6) Verify that deposits in transit at end of prior audit period were deposited promptly.[4]

(7) Compare total receipts per Sales and Cash Receipts Journal with adding machine tape of total deposits shown on the bank statements and account for any difference.

(8) Compare total withdrawals per bank statements (per adding machine tape) with total disbursements shown in Cash Disbursements Journal. Verify bank charges and bank credits.

(9) See that receipts are deposited intact daily or in accordance with regulations.

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[1] The purpose is obvious: to ensure that the intended payee actually endorsed the check. The auditor should be alert for variations between endorsements by the same firm or individuals.

[2] This may indicate collusion between a vendor and an employe. Most firms deposit checks directly, in accordance with the generally accepted requirement that cash receipts be deposited intact.

[3] This requirement provides a check against the practice of "kiting", in which a check is drawn on one bank account and deposited in another, without being recorded in the cash disbursements record, for the purpose of covering a cash shortage. Obviously, any check other than a pay check, payable to an employe should be viewed with suspicion.

[4] Deposits "in transit" must be verified with the bank to preclude their use as a ruse to conceal shortages.

(10) Foot and crossfoot cash receipts and disbursements records for the audit period. Trace totals to general ledger accounts.[1]

(11) Ascertain that reports of bank balances in excess of $10,000.00 are submitted in accordance with directives.[2]

(f) Accounts Receivable

(1) Obtain a list of open accounts at the end of the month and check balances with the subsidiary ledger or record. Prepare a summary and compare summary total with controlling account in general ledger.

(2) Age open accounts (current -- not more than 30 days, 30-60 days, and over 60 days).

(3) Indicate on the list amounts received subsequent to the audit period.

(4) Investigate delinquent accounts and ascertain steps being taken to collect such accounts.

(5) Verify that accounts written off were properly approved.

(6) Investigate credit balances and see that they are shown as liabilities on financial statement.

(7) Arithmetically check sales slips for several days and trace charges to individual accounts receivable.

(8) Investigate any personal accounts of the Mess included as Accounts Receivable.

(9) Ascertain steps being taken to collect on checks returned for insufficient funds.

(10) Confirm other accounts receivable, if believed necessary.

(g) Consumable Property Inventories (Resale Merchandise Only)

(1) Senior member of the board should prepare written instructions

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[1]A common form of fraud occurs when the cashier receives cash on account, credits the customer's account, but neglects to enter the transaction in the cash journal. This audit step should reveal such a fraud.

[2]Since bank deposits insured under FDIC are limited to $10,000.00, "the Comptroller of the Navy will request the Treasury Department to obtain a pledge of collateral to protect uninsured balances of nonappropriated fund accounts on the basis of information reported . . ." (NAVCOMPT INSTRUCTION 7820.6, Department of the Navy, Office of the Comptroller, Washington, D. C., 23 March 1955, paragraph 8).

for other board members to follow in taking the physical inventory. Such instructions should cover method for inventorying partially filled containers, the reporting of merchandise not in usable condition, and the general appearance of the storeroom.

(2) If physical count was not made directly on final inventory sheets, reconcile such original record to the final inventory sheets.

(3) Test check prices on inventory sheets with recent invoices and stock records.

(4) Check the clerical accuracy of footings and extensions of the inventory sheets and trace summary total to General Ledger Controlling Accounts.

(5) Ascertain whether the book inventories have been properly adjusted to reflect results of physical count.

(6) Test check receiving reports and other documents for the last few days of the audit period against the stock records to ascertain that they were recorded and that the merchandise is indluded in the count.

(7) Compare the physical count with the stock records and investigate any major differences.

(8) Determine that no furnishings, equipment, or supplies are included in the inventory.

(9) Make a physical count of empty and full containers having a monetary vaule (such as barrels, cases, and bottles) and list on a separate inventory sheet. After extension is made, compare total with control account in the generd ledger.

(10) Inspect storeroom facilities for proper safekeeping.

(h) Investments.

(1) Count the securities on hand and check the total with the balance shown in the general ledger account. This count should be made simultaneously with the count of cash to avoid any possible manipulation. If the securities are not on hand, obtain confirmation from the custodian thereof.

(2) Examine the securities to ascertain that they are in the name of the Mess. If the bonds are coupon bonds, see that all unmatured copies are attached. Also, see that the proceeds of matured coupons are reflected on the accounting records.

(3) Ascertain that all securities are properly safeguarded.

(i) Other Assets

(1) Ascertain that proper records are maintained in support of prepaid charges and special deposits.

(2) Calculate amounts of various prepaid charges carried on the balance sheet as a charge to future operations.

(3) Examine documentary evidence (invoices, contracts, insurance policies, etc.) in support of the prepaid charges, and verify special deposits by confirmation.

(4) See that procedure followed for amortizing or reducing the prepaid item is reasonable and is in accordance with sound business practices.

(5) Examine policies to ascertain that the insurance carried is in accordance with current directives, is adequate in coverage but not excessive.

(j) Accounts Payable

(1) Obtain copy of the trial balance of the accounts payable ledger or file and compare with open items on the invoice register (if one is maintained) and the accounts payable ledger. Also, compare the total of open accounts with the general ledger controlling account.

(2) Test check monthly statements from creditors with trial balance.

(3) Correspond with creditors regarding accounts with long outstanding balances and check replies.

(4) Check invoices or dealers' bills for approval, receipt and acceptance of goods or services.

(5) Test check invoices or dealers' bills for clerical accuracy.

(6) Review invoices for first 5 days of the moth subsequent to audit period to ascertain that they do not indicate receipt and acceptance during the month under review and should have been recorded as liabilities.

(7) Examine receiving reports for the last 5 days of the audit period to ascertain that corresponding liabilities are properly recorded.

(8) Check footings and crossfootings of invoice register.

(k) Accrued Liabilities

(1) Check calculations of the liabilities by reference to original records, such as payroll records, insurance policies, tax bills, contracts, federal tax returns, and similar items.

(2) Scrutinize expense accounts to determine if all accrued liabilities have been set up.

(l) Other Liabilities

(1) Examine adjustments to Unredeemed Coupons Account and ascertain that proper approval was obtained.

(m) Net Worth

(1) Prepare schedule of both operating surplus and reserve accounts showing changes during the audit period, giving full details for all adjustments.

(2) Examine underlying documents in support of changes made.

(n) Sales

(1) Test check the compilation of data supporting the daily entries in the Sales and Cash Receipts Journal for several days during the month.

(2) Trace the entries on the daily activity reports to cash register tapes, sales slips, etc., for the same period used in item (1) above.

(3) Select several accountability reports and trace the sales thereon to the Sales and Cash Receipts Journal. Also, compare the actual sales with the potential sales based upon the method of accountability.

(4) Are cash overages and shortages properly recorded?

(5) Trace postings from the Sales and Cash Receipts Journal to the general ledger accounts and accounts receivable subsidiary records for charge sales.

(6) Compare total sales from month to month and determine reason for any large variance.

(7) Compare gross profit percentages for each department from month to month and determine reason for variance.

(8) Test check several items on the food menu and the package store and bar price list for correct pricing in accordance with operational goals set up for the Mess or Club.

(o) Other Income

(1) Ascertain that there are signed agreements with all concessionaires.

(2) Check the computation of concessionaire reports; ascertain that the rate used agrees with concession agreements; and trace the amount shown on the reports to the Cash Receipts Journal.

(3) List any purchase discounts forfeited by late payments, and explain reasons therefor.

(p) Payrolls[1]

(1) Check the time reports for the number of hours worked to the payroll record for at least one pay period.

(2) Compare the payroll rates and tax exemption status listed on payroll to personnel records for the same period used in item (1) above.

(3) Verify computations, distribution, and payroll deductions for same period as used in item (1) above.

(4) Foot and crossfoot payroll record.

(5) Trace total payroll for one pay period to the Cash Disbursements Journal and general ledger account.

(6) Compare canceled checks with payroll and examine endorsements for the same period used in item (1) above.

(7) Observe, if possible, a pay off procedure.

(q) Purchases and Expenses

(1) Test check, for at least 10 days, invoices appearing in the Invoice Register, and review underlying documents for approval, receipt and acceptance of goods or services, computations, etc.

(2) Trace the invoices selected from the files for several days,

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[1]A common method of embezzlement is padding payrolls as to time, production, or number of employes.

after checking for receipt and acceptance of goods or services, to the Invoice Register.

(3) Trace items selected in (1) and (2) above to the stock record cards.

(4) Review transactions for first 5 days of month subsequent to audit period for any charges applicable to period under review.

(5) Scrutinize all invoices paid during the audit period to be sure that they are fully supported and stamped or marked "Paid" to prevent reuse.

(6) Compare expenses for period under review with last's month's expenses and investigate any large differences.

(7) Foot and crossfoot the Invoice Register. Trace the totals to the accounts in the General Ledger.

(8) Verify that the Government has been paid for the cost of utilities to the extent required by current directives.

(9) Verify that Mess funds have not been expended for materials and services properly obtainable from appropriated funds in accordance with current directives.

(r) Fidelity Bonds

(1) Examine all fidelity bonds and ascertain that they cover all positions having cash and property under their control.

(s) Nonconsumable Property (Furnishings and Equipment)

(1) Take an inventory of Mess-owned furnishings and equipment, in accordance with regulations. Determine that the equipment is properly identified and that the location of the item agrees with the property record information.

(2) Check the physical count with the property records and investigate any difference.

(3) Account for the proceeds on equipment sold since the last physical inventory was taken.

(4) Scrutinize the property record cards to verify that the information as to date of purchase, cost, location, and other pertinent data is shown thereon.

(5) Test check the entries on the property record cards by examining the underlying documents (invoices, evidence of receipt and acceptance, etc.) in support thereof.

(t) Regulations and Directives

(1) Check for compliance with applicable directives.

(2) Make comment to the commanding officer of any action taken in violation of existing regulations and directives.

The writer has observed that the audit of many nonappropriated fund activities is often conducted in a perfunctory manner at the station level. Perfunctory audits, like other forms of loose internal control, encourage inefficiency and fraud. It can be safely assumed that if a deliberate fraud has been committed, other than the crudest type, the accounts will nontheless balance, and the financial statements will appear to be in order. The proper performance of an internal audit, as outlined in the preceding audit instructions, requires many man-hours of skilled endeavor. Such an audit cannot be performed by merely checking arithmetic accuracy of the balance sheet and income statement, and ensuring that the books"balance." It is therefore mandatory that the Commanding Officer ensure that a strong, well-qualified and well-trained audit team is assigned to the task of internal audit of nonappropriated funds.

The foregoing has been a discussion of the audit procedures as apply to Officers' Messes, Chief Petty Officers' Messes, and Enlisted Men's Clubs ashore. The same general principles and procedures should apply to other types of nonappropriated funds. Some nonappropriated funds, notably credit unions, are audited by public accountants, which limits the internal audit role at the station level in those instances. They remain, however, subject to audit by representatives of the Comptroller of the Navy as deemed necessary.

## CHAPTER IV

## CONCLUSION

It is generally accepted that no system of accounting or internal control yet devised will positively prevent embezzlement. The skillful, sophisticated embezzler will leave a very meager trail of evidence, which may defy detection by the best system of internal controls for years. But well-devised, skillfully and consistently applied systems of accounting and internal control can go far toward preventing basically honest persons from yielding to temptation. Deviations from established methods and procedures must be detected promptly by the internal control system. Positive corrective action must be taken, for each deviation in established procedures represents a weak link in the chain of defenses against fraud and inefficiency.

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